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IN THE

# Supreme Court of the United States

OCTOBER TERM, 1941

No. 741

SKENANDOA RAYON CORPORATION,
*Petitioner,*

*against*

COMMISSIONER OF INTERNAL REVENUE,
*Respondent.*

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**Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit and Brief in Support Thereof.**

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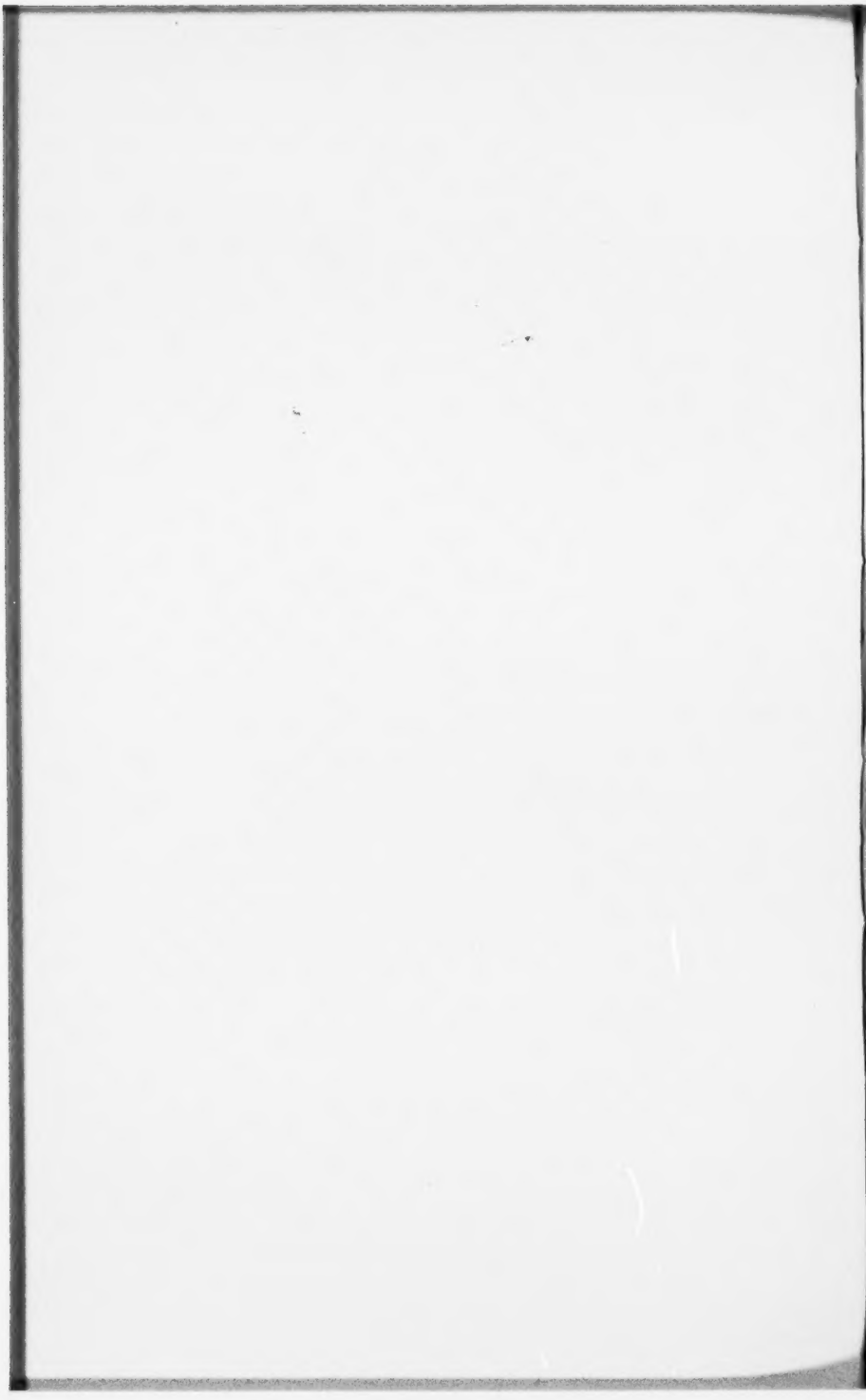

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OCTOBER TERM, 1941

No. _____

SKENANDOA RAYON CORPORATION,

*Petitioner,*

*against*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

## Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

*To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:*

Petitioner, Skenandoa Rayon Corporation, a Delaware corporation, respectfully petitions for a writ of certiorari of this court to review a judgment of the United States Circuit Court of Appeals for the Second Circuit, entered on August 16, 1941, which affirmed a decision of the United States Board of Tax Appeals entered February 6, 1941, sustaining the determination by the Commissioner of Internal Revenue of a deficiency of income tax of the petitioner for the taxable year 1937 in the amount of $54,873.09 and a deficiency in the excess profits tax for the same year in the amount of $706.87.

## Questions Presented.

1. Whether, in computing the excess profits tax on undistributed profits imposed by Section 14 of the Revenue Act of 1936, petitioner is entitled to a dividends paid credit under Section 27 (a) or (e) of such Act upon the issuance and distribution to its preferred stockholders of additional shares of its new prior preferred stock in discharge of $40 per share of arrears of dividends on its old cumulative preferred stock?

2. Whether, under Sections 115 (a), (f), or (g) or 112 (c)(1) and (2) of the Revenue Act of 1936, the additional shares of new preferred stock issued in discharge of such arrears of dividends on old cumulative dividend preferred stock are taxable in the hands of the preferred stockholders who received such new preferred stock?

3. Whether, within the provisions of Sections 112 (b)(2) and (3), (g)(1)(D) and 115 (h)(1) of the Revenue Act of 1936, the issuance of the additional shares of new preferred stock in discharge of such arrears of dividends was an exchange of preferred stock solely for preferred stock or an exchange of stock or securities solely for stock or securities and a tax-free exchange (as an incident to a reorganization by recapitalization)?

4. Whether, under Section 23 (a) of the Revenue Act of 1936, attorneys' fees paid in connection with the discharge of arrears of cumulative dividends and the reclassification of capital stock incidental thereto are deductible from gross income?

## Statutes Involved.

There are involved in this petition for certiorari the following provisions of the Revenue Act of 1936 (49 Stat. 1648): Sections 14 (a)(2) and (b); 23 (a); 27 (a), (e) and

(h); 112 (a), (b) (2) and (3), (c) (1) and (2), (g) (1); 115 (a), (f) (1) and (2), (g), (h) (1) and (2), and (j).*

## Summary Statement of the Matter Involved.

The proceeding involves the question whether, in the year 1937, the holders of 5,553 shares of petitioner's preferred stock, entitled to cumulative dividends at the rate of $7. per year, received income taxable under the Sixteenth Amendment to the Constitution by the issuance to them, at par, with their consent, as a capitalization of $222,120 from petitioner's earnings for the year 1937, of 2,221.2 additional shares of petitioner's new prior preferred stock of the par value of $100 per share. The additional shares were issued in satisfaction of $222,120 arrears of dividend accumulated on the 5,553 shares of old preferred stock, the holders of which agreed to accept the additional shares of new stock in satisfaction of $40 arrears of dividend per share on their stock. If the issuance of the additional shares was income to the recipients, then, under Section 27* of the Revenue Act of 1936, petitioner is entitled to a "dividends paid credit."

As provided in Section 27, the amount of the dividends paid credit depends upon whether the income taxable to the preferred stockholders is the actual amount of petitioner's 1937 earnings capitalized or the fair market value of the additional shares issued to discharge the $40 arrears of dividend.

The Commissioner of Internal Revenue disallowed the credit. That determination was upheld by the Board of

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* The pertinent sections of the Revenue Act of 1936 are printed in the Appendix, beginning on page 39.

Tax Appeals, and the Circuit Court of Appeals affirmed the Board's determination.

Petitioner contends that the issuance of the additional shares of new prior preferred stock and the receipt thereof by the holders of 5,553 shares of its old cumulative preferred stock constituted income taxable to such stockholders under the Sixteenth Amendment, because the effect thereof was the equivalent of a distribution to them of $222,120 in cash or, alternatively, of a dividend in shares of the new preferred stock. Petitioner further claims that by the receipt of the 2,221.2 additional shares of new prior preferred stock the proportional interest of the recipients in the net assets of petitioner was increased over what it was before the preferred stockholders received the additional shares and that, therefore, under the rule as previously stated by this court (in *Koshland* v. *Helvering,* 298 U. S. 441), taxable income was received.

The question arises under the following circumstances:

As of July 1, 1937 petitioner had issued and outstanding 5,632 (out of 14,247 authorized) shares of its convertible preferred stock, the holders of which were entitled to cumulative preferred dividends at the rate of $7 per annum (198*). No dividends were declared on such issued preferred stock from January 1, 1931 to July 1, 1937, so that as of July 1, 1937 the arrears of dividend on such stock amounted to $45.50 per share, or an aggregate of $256,256 on the 5,632 shares outstanding (199).

During the years 1931 to 1936, inclusive, except for the year 1933, petitioner operated at a loss and at the end of 1936 had a deficit of $15,802.63 (245). The petitioner's net

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* Figures in parentheses, unless otherwise indicated, refer to folios in the transcript of the record in the Circuit Court of Appeals.

profits, before deduction for Federal income taxes, amounted to $320,392.51 at June 30, 1937 (244), more than enough to pay the full accumulated arrears of dividend, and amounted to $352,055.33 at the end of the year 1937 (244).

During the year 1937 there was in effect the Revenue Act of 1936. Section 14 of that Act imposed a surtax at graduated rates upon undistributed profits of corporations. The statute also provided for a dividends paid credit in determining the undistributed net income subject to tax. The credit under Section 27(a) was "the amount of dividends paid during the taxable year." Section 27(h) provided, however, that "If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title * * *, no dividends paid credit shall be allowed in respect to such part."

In April 1937 petitioner's officers and directors presented to the preferred stockholders a plan to discharge the $45.50 of arrears of dividend per share on petitioner's outstanding shares of preferred stock by issuing at par to preferred stockholders accepting the proposal .4 of a share of new (authorized and reclassified) 5% cumulative dividend prior preferred stock of the par value of $100 per share, plus $5.50 in cash (203-206).

The detailed machinery to carry out the plan included provisions for a recapitalization of petitioner and a reclassification of both the authorized and unissued shares, as well as the outstanding shares. The reclassification, among other things, changed the dividend rates (effective after the reclassification) from 7% to 5%. The plan provided for an exchange of each share of old 7% dividend stock for one share of the reclassified 5% dividend stock on a share-for-share basis. However, no tax question

arises from those exchanges. The tax question arises only from the receipt of the additional shares of new prior preferred stock.

In carrying out the plan the arrears of $45.50 per share were paid in part by transferring from earnings accrued in the year 1937 to capital the requisite amount ($222,120) as the consideration for the issuance of the new prior preferred stock at the rate of .4 of a share (or a total of 2,221.2 shares) in respect of each of the 5,553 shares of preferred stock then outstanding, the holders of which accepted the petitioner's proposal.

The plan emphasized that in accepting the proposal made therein the preferred stockholders "will thereby release, * * * their claim to all dividends accrued and in arrears on the outstanding Cumulative Preferred Stock" (219; see also 17, 172, 206 and 224).

The holders of 5,553 shares out of a total of 5,632 outstanding shares of preferred stock accepted the petitioner's proposal, leaving only the holders of 79 shares outstanding who did not accept the proposal (227). The holders of the 79 non-accepting shares were paid $45.50 per share, or a total of $3,594.50 cash (47).

The Commissioner eventually allowed petitioner a dividends paid credit for the amount distributed to the holders of the 79 shares and for the amount of the distribution at the rate of $5.50 per share made to the holders of the 5,553 shares who accepted petitioner's proposal (247).

The Commisioner, however, denied petitioner's claim for a dividends paid credit in respect of the $222,120, and rejected petitioner's contention that the 2,221.2 shares of new prior preferred stock of the par value of $100 each distributed at the rate of .4 of a share on each share of the

5,553 shares of preferred stock, the holders of which accepted petitioner's proposal, was in effect a distribution of $222,120 from petitioner's 1937 earnings.

It is not disputed, however, that pursuant to the stockholders' consent the amount of $222,120 was actually transferred from petitioner's 1937 earnings to capital account and that such sum constituted the capital received by petitioner as the consideration for the 2,221.2 shares of new prior preferred stock issued to discharge $40 per share of arrears of dividend (238, 240, 247; 36, 37).

In connection with the preparation and carrying out of the plan, petitioner employed attorneys who were paid $15,000, which was the reasonable value of the services (246). This expense was claimed as a deduction from petitioner's gross income, but was disallowed by the Comsioner (246).

The petitioner's proposal to issue .4 of a share of new preferred stock plus $5.50 in cash in satisfaction and discharge of $45.50 per share of arrears of dividend on the old preferred stock was also coupled with an offer to exchange one share of the (reclassified) preferred stock for one share of old preferred stock on a share-for-share basis. That exchange of shares (which involves no taxable gain), however, did not prevent the primary transaction from being, in substance and effect, a distribution of petitioner's 1937 earnings.

Looking only at matters of form and disregarding the substance, the Commissioner, the Board of Tax Appeals and the Circuit Court of Appeals concluded that the receipt of the 2,221.2 shares of new 5% prior preferred stock as the consideration for the release of $40 arrears of dividend per share on the old cumulative preferred stock, along with the exchange of shares of the new, re-

classified preferred stock for shares of the old preferred stock, on a share-for-share basis, was a "reorganization" within the meaning of Section 112(b)(2), (3) and (c)(1) and 112(g)(1)(D) of the Revenue Act of 1936, that it was a "non-taxable exchange" and that there was "no taxable gain" to petitioner's preferred stockholders. Accordingly, it was held below that the preferred stockholders did not receive taxable income and that petitioner should not be allowed any dividends paid credit in respect of the $222,120 transferred from petitioner's 1937 earnings (284; see also opinion and decision of the Circuit Court of Appeals appended to the Transcript of Record, pp. 128-131, fols. 128-133).

Likewise, both the Board of Tax Appeals and the court below affirmed the determination of the Commissioner that petitioner's legal expense of $15,000 in connection with the transaction was a capital expenditure in connection with a "recapitalization" and the expense was disallowed as an ordinary and necessary expense (285).

## Jurisdictional Statement.

The jurisdiction of this court arises by virtue of the provisions of Section 240(a) of the Judicial Code (as amended) 28 U. S. C., Sec. 347; 26 Stat. 828, as amended by 36 Stat. 1157 and 43 Stat. 938. The judgment of the Circuit Court of Appeals for the Second Circuit was entered August 16, 1941 (Record, p. 131, fol. 133). This petition for certiorari was filed prior to November 16, 1941.

## Rulings of the Circuit Court of Appeals and the Board of Tax Appeals.

The Board of Tax Appeals held that the transaction involved a non-taxable exchange within the purview of

Sections 112(b)(2), (3) and (c)(1) and 112(g)(1)(D) of the Revenue Act of 1936, and that, therefore, under the provisions of Section 27(h) of the same Act no dividends paid credit should be allowed to petitioner; in so ruling it held that the receipt of the new stock was not taxable in the hands of the stockholders under Section 115(a) and (g) of the Revenue Act of 1936 (248-285). The findings of fact of the Board of Tax Appeals appear in the record at folios 196 to 247. Although the petitioner contended, in the alternative, that the distribution of additional new prior preferred stock should be considered as constituting the distribution of a stock dividend under Sections 27(e) and 115(f) (362, 363), the Board Member confined his decision to the question whether the transaction should be given the effect of a cash dividend, taxable and paid (254). (See discussion *infra,* at pages 30 to 32.) The Board held that the expense for attorneys' services in carrying out the transaction was a capital expense and not deductible as an ordinary and necessary expense (284, 285). Petitioner applied for leave to reconsider or reopen the case, or in the alternative, to have the decision reviewed by the Board (286-309). On December 18, 1940 orders were handed down denying such application (310-315). The order of the Board of Tax Appeals upholding the Commissioner's claimed deficiencies in income and excess profits taxes in the respective amounts of $54,873.09 and $706.87 for the year 1937 was entered on February 6, 1941 (316-318).

The Circuit Court of Appeals affirmed the order of the Board of Tax Appeals (Record, p. 131, fol. 132).

## Reasons Relied On For the Allowance of the Writ of Certiorari.

**(1) The Circuit Court of Appeals has decided an important question in the administration of the federal income tax laws in a way probably untenable, because in conflict with the provisions of Sections 112 (c)(2) and 115 (a), (f) and (g) of the Revenue Act of 1936 and the decisions of this court.**

The Circuit Court of Appeals (as well as the Board of Tax Appeals and the Commission) failed to appreciate that even if petitioner's proposal is considered as a distribution pursuant to a plan of reorganization and within Section 112 of the Revenue Act of 1936, as the court below held, nevertheless the distribution had the effect of the distribution of a taxable dividend under the provisions of Section 112(c)(2) which reads as follows:

> "(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property."

Neither the Circuit Court of Appeals nor the Board referred to the foregoing section of the Act, although it was expressly brought to their attention.

The court below also failed to apply the rules announced by this court in the decisions in three cases which were relied upon below. Those cases are:

*Eisner* v. *Macomber,* 252 U. S. 189;
*Koshland* v. *Helvering,* 298 U. S. 441;
*Helvering* v. *Gowran,* 302 U. S. 238.

Heretofore, in *Eisner* v. *Macomber, supra* (252 U. S. 189), this court has held that a distribution by a corporation of shares of common stock as a dividend on outstanding common stock does not constitute income taxable within the meaning of the Sixteenth Amendment, because after the distribution the shareholder held exactly the same interest in the net assets of the corporation as he did before the distribution of common stock was made.

In *Koshland* v. *Helvering, supra* (298 U. S. 441), this court held that a distribution of common stock in payment of a dividend on outstanding shares of preferred stock so increased the proportionate interest of the stockholder in the net assets of the corporation that after the distribution the stockholder had an interest different from that which his former stockholdings represented and that, therefore, the preferred stockholder had received income taxable under the Sixteenth Amendment, even though at that time Congress had not taxed such income.

In *Helvering* v. *Gowran, supra* (302 U. S. 238), this court held that a dividend on outstanding common stock payable in shares of preferred stock was also income which Congress could have taxed, but the taxation of which was prevented by reason of the provisions of Section 115(f) of the Revenue Act of 1928, as then in effect.

In the case at bar the corporation petitioner distributed shares of its new 5% prior preferred stock to holders of its old cumulative dividend preferred stock in discharge of arrears of dividend on such stock, the distribution being effected through a capitalization of earnings with the consent of the preferred stockholders accepting the distribu-

tion. While, so far as we know, such a distribution of new preferred stock on outstanding preferred stock has never before been considered by this court in determining whether or not the receipt of such preferred stock constitutes taxable income within the meaning of the Sixteenth Amendment and, therefore, is taxable under Section 115(a), (f) or (g) of the Revenue Act of 1936, nevertheless, it is respectfully submitted that, under the rules stated in the decisions mentioned, the distribution should be held to constitute income taxable to the recipients.

Both in the court below and before the Board of Tax Appeals petitioner urged that, considering the distribution as a distribution in stock (as an alternative to petitioner's primary contention that the distribution was the equivalent of a cash dividend), the receipt of the additional shares of preferred stock under the plan so changed the proportionate interest of the accepting preferred stockholder in the net assets of petitioner that taxable income had been received under the rule stated in *Koshland* v. *Helvering, supra.* Nevertheless, that contention was completely ignored and was not considered either by the Board or the court below.

It is impossible to reconcile the decision of the court below with the express provisions of Sections 112 (c)(2) and 115 (a), (f) and (g) of the Revenue Act of 1936 and the rules previously stated by this court.

It is not disputed that petitioner did distribute 2,221.2 additional shares of its new prior preferred stock to the holders of 5,553 shares of its old cumulative dividend preferred stock, that in the process, with the consent of such preferred stockholders, $222,120 of petitioner's 1937 earnings were consumed and that thereby the proportionate interest of the recipients of the new stock in the net assets of petitioner was substantially increased.

Therefore, it is respectfully submitted that the decision of the court below, affirming the Board's determination, is in conflict with the decision of this court in *Koshland* v. *Helvering, supra.*

**(2) The Circuit Court of Appeals has decided an important question in the administration of the federal income tax law relating to distributions by corporations which has not been, but should be, settled by this court.**

It is common knowledge that a large number of corporations have outstanding issues of cumulative dividend preferred stocks on which substantial amounts of arrears of dividends are unpaid. Such arrears, in the aggregate, amount to many millions of dollars and affect many thousands of holders of cumulative dividend preferred stocks. Various plans are being and will continue to be considered by the management of such corporations and the holders of such preferred shares to adjust and discharge the unpaid arrears by the issuance of additional shares of preferred stock, thereby capitalizing earnings. It is respectfully submitted that a decision on the plan presented in the case at bar will be helpful, not only to the Commissioner of Internal Revenue, but to the public generally, in knowing whether such plans will involve the receipt by the preferred stockholders of income taxable under the Sixteenth Amendment.

At present the situation is confusing, both to corporations and to the preferred stockholders, as well as to the Bureau of Internal Revenue. For example, upon the carrying out of the petitioner's plan, it is known that several holders of preferred stock reported the receipt of the additional shares of new prior preferred stock under the plan as income and paid a tax thereon for the year 1937. Petitioner has by circular letter advised all preferred stockholders of the decisions of the Board of Tax Appeals and

of the Circuit Court of Appeals herein, because of the bearing that such decisions may have on claims for refund of tax paid by petitioner's preferred stockholders.

In addition, petitioner has informed its preferred stockholders by a further circular letter that it would petition this court for a writ of certiorari to review the judgment of the Circuit Court of Appeals.

The importance of the problem of adjusting arrears of cumulative dividends on preferred stocks was recently indicated by the New York Court of Appeals in its opinion in the case of *Davison* v. *Parke, Austin & Lipscomb, Inc.*, 285 N. Y. 500 (decided May 29, 1941), where the court said (at page 506):

> "The issue thus presented is today one of great importance. It is common knowledge that during the past few years many corporations have been unable to pay dividends either upon common stock or preferred stock and that large amounts of unpaid cumulative dividends, constituting as they do a first charge upon future profits, have a tendency to discourage new investment. * * *"

Until the federal income tax question, such as is presented in the case at bar, has been finally determined by this court, there will remain unsettled questions with respect to the tax liability, not only of petitioner's preferred stockholders, but of many other corporations and preferred stockholders similarly situated, which should be settled by this court.

A brief in support of this petition is presented herewith.

Respectfully submitted,

HORACE R. LAMB,
*Attorney for Petitioner.*

Dated: November 12, 1941.